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## Impact Of Tax Reform Debated

Full Diet approval of a broad tax reform program has not stilled domestic debate on the merits and shortcomings of the changes. The government continues to see mainly positive results, but many private economists and academicians argue that the changes are only the first step toward truly comprehensive tax reform.

According to a consensus of government economists, the planned tax reductions, including cuts in personal and corporate income taxes, will outweigh the introduction of a 3 percent consumption tax and some other increases by roughly Y2.6 trillion ($20.8 billion at Y125=$1.00) in FY 1989, which begins April 1. The changes will add approximately 0.2 percentage point to the nation's inflation-adjusted gross national output for the 1990-1993 fiscal years. The reforms also are expected to pull in more imports, reducing Japan's current account surplus by approximately $5 billion annually in fiscal years 1988-1991, according to the government. Tokyo expects the share of total revenue derived from direct taxes to decline from 73 percent in FY 1987 to about 67 percent in

FY 1989. Observers have pointed to the government's past heavy reliance on direct taxes as an indicator of the tax system's inequities. The only downside to the changes is a projected increase in consumer prices of about 1.1 percent for FY 1989.

Foreign producers of alcoholic beverages could benefit handsomely from upcoming changes in liquor taxes. Replacing the current ad valorem tax structure with a specific tax system should reduce the tax burden significantly on imported beverages and sharpen their competitive position vis-a-vis domestic products. A 760-milliliter bottle of top-grade imported whiskey now costs around Y3,170 ($25.36) but could cost as little as Y2,450 ($19.60) after the tax changes. Many domestic distillers, moreover, will face higher taxes; the price of a 640-ml bottle of domestic whiskey could jump from Y670 to Y1,100 ($5.36 to $8.80). European Community exporters have urged Japan to make these changes for many years. American producers of wines and whiskey, too, are likely to benefit.

Also expected to reflect the impact of tax reform are the domestic prices of a wide range of big-ticket or luxury items. Current commodity taxes, for example, are higher for large cars and motorcycles than smaller models. The 3 percent consumption tax will replace current commodity taxes over five years, sharply reducing levies in some cases (see Table). Domestic car makers already are gearing up for a price war during the few months before the tax changes take effect, anticipating that consumers will try to delay car buying until the lower rates kick in. At the same time, importers of foreign cars are planning to pass on as much of the tax reduction as possible in order to increase their share of the Japanese market.

Japan's Motor Vehicle Taxes

(in percent)

| | Current Commodity Tax | FY 1989-FY 1991 | After FY 1991 |
|---|---|---|---|
| Cars | | | |
| Large (over 2,000 cc) | 23.0% | 6.0% | 3.0% |
| Medium (over 550 cc) | 18.5 | 6.0 | 3.0 |
| Small (under 550 cc) | 15.5 | 3.0 | 3.0 |
| Vans | | | |
| Large (over 550 cc) | 10.5 | 3.0 | 3.0 |
| Small (under 550 cc) | 5.5 | 3.0 | 3.0 |
| Three-Wheel Cars and Motorcycles | | | |
| Large (over 150 cc) | 10.0 | 3.0 | 3.0 |
| Small (over 50 cc) | 5.0 | 3.0 | 3.0 |

Sales of home appliances and other consumer durables also may get a boost. Both the current 20 percent tax on large refrigerators, air conditioners and large televisions (with screens of 28 inches or greater) and the 15 percent tax on washing machines, videocassette recorders, cameras and smaller televisions will be replaced by the 3 percent consumption tax. Restaurant meals, theater tickets and sports equipment also will be taxed at reduced levels, helping to spur domestic consumption.

Charges for utilities are expected to change only slightly, if at all. The cost of gas for cooking and heating will rise slightly as the tax rate increases from 2 percent to 3 percent. Electric bills are likely to decline somewhat as the tax rate will fall from 5 percent to 3 percent, translating into a Y117 ($0.94) reduction in an average household's monthly expense. The Ministry of International Trade and Industry currently is mulling a reduction in basic utility rates to counterbalance the tax changes where necessary.

Bills for water, mail, telephone and other services will rise slightly after losing their tax-exempt status. The Home Affairs Ministry is recommending that local governments pass on the full 3 percent increase to consumers for water, sewer, trash and public transportation services. The cost of mailing a letter also will increase a tiny bit: the rate for letters will rise to Y62 ($0.50) from Y60 ($0.48) and a postcard will cost Y41 ($0.33) to mail after April 1, compared with the present Y40 ($0.32). Train, bus and taxi fares are likely to be raised, while the cost of air travel is expected to decline when a uniform 3 percent tax is applied.

All these projections, critics point out, are based on two critical assumptions: that businesses will not raise prices more than 3 percent and that they will pass on the majority of any tax savings to consumers. Although deregulation has reduced the government's means of directly influencing prices, Ministry of Finance officials and the Bank of Japan have stated clearly that price increases in excess of 3 percent will be examined carefully. The Japan Fair Trade Commission will allow small businesses to form cartels to smooth the introduction of the new consumption tax but will limit any price increase to 3 percent. A recent Nihon Keizai Shimbun survey of Japanese businesses revealed that most did not think prices would jump excessively and that they expected to raise prices by 3 percent or less.

Critics respond that the tax reforms will leave many inequities in place. Foremost among the complaints is that the changes do not tighten the income reporting rules for farmers or self-employed people; they account for the majority of tax evasion. The lax rules have become a sore point with salaried workers who cannot avoid automatic tax withholding from their paychecks. Particularly galling to many is that doctors and religious organizations will retain preferential tax treatment under the reformed system.

Many outside the government also contend that the increases in national and local personal income tax credits and deductions are insufficient to offset the 50 percent jump in the cost of living since 1977, when deductions were last raised. Others point out that only couples making more than Y7 million ($56,000) will be able to take advantage of many of the new rules. Most private economists also feel that the new consumption tax will be more regressive than the government foresees despite the exemptions for food, housing, medical and education costs. On balance, many business analysts calculate that only 60 percent of Japan's households will see their total tax bills reduced, compared with the government's estimate of nearly 100 percent.

The debate over the impact of the controversial tax reforms should be resolved within the next 12 months. Tacitly recognizing that more needs to be done, however, the government now is considering another round of reductions in income and other taxes for the coming fiscal year.

Jon Choy

Both sides recognize the mutually damaging effects of aviation sanctions. This might be one reason why Washington has held off in imposing sanctions against JAL, which has refused to allow United to issue JAL tickets in Japan through United's computer reservation system. (DOT announced December 14 that it would prohibit all U.S. carriers that operate computer reser- vation systems in the United States from selling JAL tickets here if Japan's largest airline refused to alter its position within 31 days.)

Unfortunately, this recognition still has not enabled the United States and Japan to bridge the philosophical chasm that continues to block conclusion of a new, comprehensive bilateral aviation agreement (see JEI Report No. 13A, April 1, 1988). The Flying Tiger/NCA dispute and the JAL ticketing issue represent still more operational issues that divert negotiators' time and energy from tackling more difficult issues, such as the overall expansion of route authority, that go to the heart of the regulatory debate.

Barbara Wanner

## Tokyo Extends Car Export Restraints For Ninth Year

The conventional wisdom is not always right. That truism was underscored January 10 when International Trade and Industry Minister Hiroshi Mitsuzuka disclosed that Japan's car exports to the United States would remain capped at 2.3 million units through March 1990 (see JEI Report No. 44B, November 18, 1988). Trade and industry analysts on both sides of the Pacific had argued that the end of Ronald Reagan's presidency afforded Tokyo a now-or-never political opportunity to return to unrestricted bilateral trade in cars since one of his administration's first foreign economic policy moves was to maneuver the Japanese government into limiting U.S.-bound car shipments.

The export figures provided an equally strong economic case for an end to managed trade in cars, according to the conventional wisdom. Shipments were 85,851 vehicles below the 2.3-million-unit ceiling in the April 1987-March 1988 period, and they are likely to fall short of the quota by a similar volume in the current fiscal year. Exports through November totaled 1,479,604 units or 10.4 percent less than in the year-earlier period, which works out to an 80,600-unit annualized shortfall in FY 1988.

The flip side of the continued cutback in exports, analysts noted, was another drop in U.S. sales of Japanese-made vehicles in 1988. After 11 rounds of price hikes since September 1985 averaging at least $3,000 for the major nameplates, sales of cars imported from Japan, which had fallen 8.9 percent in 1987, dipped 3.4 percent last year to 2,088,323 units. This decline trimmed the market share of Japanese-made cars from 21.2 percent to 19.7 percent, the lowest figure since 1984 (see Table). Adding in the expanding volume of cars assembled in this country by Japanese automotive makers obviously changed the sales numbers but not the conclusion that Japan's nine car manufacturers were fighting an uphill battle in 1988. Their American marketing units retailed 2,449,523 cars, 2.6 percent more than 1987's then-record total, but the market share captured by Japanese nameplates slipped from 23.4 percent to 23.1 percent.

These export and sales figures alone proved that Japan's restraints on U.S.-bound car shipments have become irrelevant, the conventional wisdom said,

## U.S. Retail Car Sales, 1983-88

(units)

| Manufacturer/Seller | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|
| **Japanese Imports** | | | | | | |
| Toyota Motor Corp. | 555,766 | 557,981 | 620,047 | 633,914 | 583,809 | 616,529 |
| Honda Motor Co., Ltd. (incl. Acuras) | 350,670 | 374,819 | 406,413 | 458,268 | 421,688 | 393,360 |
| Nissan Motor Co., Ltd. | 521,902 | 485,298 | 535,372 | 494,294 | 409,476 | 360,745 |
| Mazda Motor Corp. | 173,388 | 169,666 | 211,093 | 222,676 | 206,354 | 224,719 |
| Fuji Heavy Industries, Ltd. (Subaru) | 156,840 | 157,385 | 178,175 | 179,100 | 175,864 | 155,946 |
| Mitsubishi Motors Corp. | 32,755 | 39,104 | 49,734 | 49,436 | 67,954 | 70,075 |
| Isuzu Motors Ltd. | 20,731 | 17,233 | 26,953 | 38,910 | 39,587 | 24,520 |
| Daihatsu Motor Co., Ltd. | 0 | 0 | 0 | 0 | 0 | 11,460 |
| Suzuki Motor Co., Ltd. | 0 | 0 | 0 | 0 | 0 | 734 |
| Mitsubishi Motors Corp./Chrysler Corp. | 103,569 | 91,718 | 105,213 | 135,528 | 120,337 | 113,800 |
| Isuzu Motors Ltd./General Motors Corp. | 0 | 2,077 | 53,593 | 99,380 | 76,852 | 68,347 |
| Suzuki Motor Co., Ltd./General Motors Corp. | 0 | 10,927 | 31,267 | 60,983 | 60,359 | 48,088 |
| **Domestic Makes** | | | | | | |
| General Motors Corp.* | 4,053,561 | 4,587,508 | 4,607,458 | 4,532,798 | 3,555,538 | 3,641,542 |
| Ford Motor Co.** | 1,571,321 | 1,979,317 | 2,070,392 | 2,066,507 | 2,019,783 | 2,205,336 |
| Chrysler Corp. | 841,622 | 986,998 | 1,139,936 | 1,173,463 | 962,057 | 1,062,782 |
| American Motors Corp. | 193,351 | 190,255 | 123,449 | 72,848 | | |
| Volkswagen of America Inc. | 85,045 | 73,838 | 77,535 | 73,912 | 61,064 | 24,939 |
| Honda of America Manufacturing, Inc. | 50,402 | 133,601 | 145,976 | 235,247 | 316,618 | 375,625 |
| New United Motor Manufacturing Inc./ General Motors Corp. | 0 | 0 | 35,594 | 170,507 | 134,956 | 96,868 |
| New United Motor Manufacturing Inc./ Toyota Motor Sales USA Inc. | 0 | 0 | 0 | 7,281 | 44,853 | 57,637 |
| Nissan Motor Manufacturing Corp. U.S.A. | 0 | 0 | 39,794 | 52,602 | 119,678 | 112,125 |
| Mazda Motor Manufacturing (USA) Corp./ Mazda Motor of America, Inc. | 0 | 0 | 0 | 0 | 1,671 | 31,331 |
| Mazda Motor Manufacturing (USA) Corp./ Ford Motor Co. | 0 | 0 | 0 | 0 | 0 | 77,763 |
| Toyota Motor Manufacturing, U.S.A., Inc. | 0 | 0 | 0 | 0 | 0 | 14,717 |
| Total Japanese Imports | 1,915,621 | 1,906,208 | 2,217,860 | 2,372,489 | 2,162,280 | 2,088,323 |
| Total Imports | 2,385,734 | 2,441,713 | 2,841,063 | 3,239,043 | 3,144,048 | 3,065,404 |
| Total Domestic Makes | 6,795,302 | 7,951,517 | 8,204,721 | 8,214,662 | 7,081,262 | 7,526,034 |
| Total Market | 9,181,036 | 10,393,230 | 11,041,784 | 11,453,705 | 10,225,310 | 10,591,438 |
| Market Share of Japanese Imports | 20.9% | 18.3% | 20.1% | 20.7% | 21.2% | 19.7% |

*Starting in 1985 includes the Nova made by New United Motor Manufacturing Inc.
**Starting in 1988 includes the Probe made by Mazda Motor Manufacturing (USA) Corp.

Source: Automotive News

but if any additional evidence was needed, Detroit's recent financial performance supplied it. Automotive analysts predict that the Big Three's net income topped $11 billion in 1988 -- well above the existing all-time-high profit figure of $9.8 billion set in 1984 and at least 15.8 percent higher than 1987's earnings. Sales of cars built in North America by General Motors Corp., Ford Motor Co. and Chrysler Corp. were up 5.2 percent last year to 6,735,029 units, thanks to the aggressive use of incentives and a stronger-than-expected car market. This total admittedly was 14.8 percent below the figure for 1985 -- the industry's best year for U.S. car sales in the 1980s, but record-breaking Big Three truck sales swelled the bottom line and that's what counts in Detroit.

If the arguments supporting an end to managed trade in cars were so persuasive, why did Tokyo defy the conventional wisdom and extend the shipment restraints for a ninth year? For the record, MITI officials said they were not convinced that the cutback in exports would continue. Although monthly exports were running well behind year-earlier levels in the April-August period, the margin narrowed in both September and October. November shipments were 4.5 percent higher than the comparable 1987 number, and the increase in December is thought to have been even bigger. In reality, though, the decision to leave the quotas in place for FY 1989 was strictly political, dictated by worries about a resurgence of protectionism in Washington in an era of $50 billion-plus bilateral trade deficits.

MITI Minister Mitsuzuka held out the possibility that the export limits would be lifted before March 1990 if shipments declined over a sustained period; so had his predecessor (see JEI Report No. 6B, February 12, 1988). But having passed up what most analysts regarded as a unique opportunity to end the restraints, the Japanese government is unlikely to take this step anytime soon.

Susan MacKnight

Notes

FSX - U.S. and Japanese industry have reached an agreement concerning how to divide the development work on Japan's next-generation fighter support aircraft, dubbed the FSX. Although a government-to-government agreement, concluded November 29, 1988, formally launched joint development of the FSX, Mitsubishi Heavy Industries, Ltd. and General Dynamics Corp., the prime contractor and main subcontractor, respectively, remained embroiled in sometimes acrimonious negotiations over who would do what -- principally in the area of wing design (see JEI Report No. 46B, December 9, 1988). Under a January 12 agreement, General Dynamics will manufacture the wings for one of the six prototypes scheduled to be built by 1993. Overall, the accord guarantees the American defense subcontractor approximately 40 percent of the project's research and development work.

The wings will be made from composite materials using the most sophisticated technologies. General Dynamics would like to use this know-how to upgrade its F-16's wings and has argued that only by participating in prototype production can it gain the knowledge necessary to do this. MHI has been reticent about transfering the technology due, in part, to concerns that it would be subsidizing improvements to "the competition's" product.